STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MACBET REALTY CORP.	:	DETERMINATION
for Revision of a Determination or for Refund of Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	

Petitioner, Macbet Realty Corp., c/o Max Migdol, 647 Hudson Street, New York, New York 10014, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law (File No. 804684).

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on July 25, 1988 at 3:00 P.M., with all briefs to be filed by November 15, 1988. Petitioner appeared by Goldberg, Weprin and Ustin, Esqs. (Andrew W. Albstein, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel.

ISSUE

Whether petitioner's transfer of a leasehold interest was properly held subject to tax under Tax Law Article 31-B.

FINDINGS OF FACT

1. Petitioner, Macbet Realty Corp. ("Macbet"), was formed by Max Migdol in 1972. Macbet's stock was owned by Mr. Migdol and his wife, and Mr. Migdol was president of and also actively managed petitioner. Mr. Migdol has been an active investor, owner and manager of residential properties in New York Cityfor the past 33 years and has, during such time, owned approximately 40 to 60 such properties.

2. In or about 1971, Mr. Migdol purchased certain premises located at 224/226 East 21st Street, Borough of Manhattan, New York, New York. These premises consisted of a total of 50

apartments, of which 41 were then vacant and 9 were occupied. Mr. Migdol obtained a building loan from Knickerbocker Savings Bank to finance renovation of the premises. During the years 1971 and 1972, Mr. Migdol renovated the premises such that after the renovation the 50 apartments were divided into 42 rent-stablized apartments and 8 rent-controlled apartments.

3. On or about April 1, 1974, Mr. Migdol transferred ownership of the premises to one Harvey Levine. At the same time, Mr. Levine leased the premises back to Mr. Migdol under what is known as a "net" lease. The subject net lease required Mr. Migdol, as lessee, to pay all expenses of operation of the premises including, inter alia, all taxes, fuel, maintenance, superintendent, repairs, water and sewer expenses. In addition to all of such operating expenses, Mr. Migdol was to pay annual rent to Mr. Levine in an amount equal to the cost of amortizing the mortgage on the property (which mortgage had been assumed by Mr. Levine) plus a percentage of the additional amount ($150,000.00) for which Mr. Migdol sold the premises to Mr. Levine.[1]

4. This net lease commenced on April 1, 1974 and was, by its terms, to run for a period of 33 years through March 31, 2007. In addition, under the terms of the lease, the lessee (Mr. Migdol) was entitled to exercise options for renewal of the lease for two additional 33-year periods. Under the terms of the net lease, Mr. Migdol was entitled to sublease the apartments in the premises to various tenants.

5. Pursuant to the terms of the net lease, assignment thereof by the lessee was permitted without the prior written consent of the landlord so long as the leasee was not in default of any of the terms and conditions of the lease. If such an assignment were to occur, the assignee was required to assume all of the obligations of the leasee/assignor, and the leasee/assignor was to promptly advise the landlord in writing of the assignment (via a duplicate original counterpart of the assignment document). The net lease provides that upon such assignment (and delivery to the landlord of such duplicate original of the instrument of assignment) the leassee/assignor was to be released from the performance of all the terms, convenants and conditions of the lease thereafter to be performed by the assignee. There is no evidence that petitioner was in default in any manner under the net lease at any time.

6. On November 1, 1976, Max Migdol assigned the subject net lease to petitioner, Macbet Realty Corp, and petitioner operated the premises thereafter.

7. On July 2, 1986 two contracts relative to the subject premises were entered into. Petitioner, as the net lessee, entered into a contract with 222-21st Street Associates, for the assignment of the net lease held by petitioner. At the same time, Harvey Levine as the owner of the fee, entered into a contract of sale with the same 222-21st Street Associates for the transfer of the fee interest in the premises. The selling price under the contract for the assignment of the lease was $999,999.00, while the selling price for the fee interest was $1,400,000.00. Each of these contracts was dependent upon the successful completion of the other contract (that is, the sale of the fee was conditioned upon the completion of the assignment of the net lease and, reciprocally, the contract for the assignment of the net lease was conditioned upon closing of title on the fee). It is the transfer of the leasehold interest, by assignment, and specifically the amount of consideration therefor, which is at issue herein.

8. On November 6, 1986, petitioner submitted requisite transferor and transferee questionnaires (Forms TP-580 and 581) in connection with the transfer of the leasehold interest, requesting therewith the issuance of a Statement of No Tax Due on such transfer. However, the Division of Taxation issued a Tentative Assessment against petitioner seeking tax due under Tax Law Article 31-B ("gains tax") in the amount of $99,999.00. Petitioner paid such amount and,

---

[1]In summary, the annual "rent" amount paid to Mr. Levine was equal to all annual mortgage expenses, plus 10% of the $150,000.00 amount for each of the first five years of the lease with such percentage to increase by 1% per five-year period throughout the remaining term of the lease.

subsequently, submitted a claim for refund of the amount paid.

9. By letter dated May 1, 1987, the Division of Taxation denied petitioner's claim for refund.

10. Petitioner's president, Mr. Migdol, appeared and gave testimony at the hearing. Mr. Migdol explained that he never had any problem filling vacancies at the premises, noting that the particular area in which the premises are situated is a "prime" area where residential rental apartments for lower and middle income persons are always in high demand. Mr. Migdol also offered an explanation as to how he arrived at the selling price ($999,999.00) for the assignment of the lease, as follows:

> (a) The amount of rental income generated by the premises during the year 1986 was totaled. Such total, $245,751.68, consisted of $239,426.16 from the 42 rent-stabilized apartments and $6,325.52 from the 8 rent-controlled apartments.
>
> (b) The amount of actual expenses incurred in operating the premises in 1986 was calculated. This total, $69,800.00, consisted of the following items: gas ($18,000.00), superintendent ($3,600.00), electricity ($2,100.00), insurance ($7,400.00), repairs ($10,100.00), water and sewer ($5,200.00), and real estate taxes ($23,400.00).
>
> (c) Mr. Migdol then calculated (by projection) the total rental income to be received over the life of the lease. This calculation reflects petitioner's so-called "worst case scenario". In essence, petitioner utilized a 3% per year increase over the amount of 1986 rental income to be received from the 42 rent-stabilized apartments and a 2% per year increase in income over the 1986 amount of rental income to be received from the 8 rent-controlled apartments. Projecting these increases in rental income over the life of the lease results in a calculation of $7,484,085.01 in total rental income.
>
> (d) Mr. Migdol also similarly calculated a projection of the total expenses to be paid over the life of the lease. This calculation was made by using the $69,800.00 total of 1986 operating expenses and increasing such amount by 5% each year. These yearly operating expense amounts were then added to the yearly amounts of rent to be paid under the terms of the lease (see___, Finding of Fact "3", supra), with such annual amounts of operating expenses plus rental expenses totalled to arrive at $3,968,623.62 in total expense over the life of the lease.
>
> (e) The total lease expenses, as projected ($3,968,623.62), were then subtracted from the total lease income, as projected ($7,484,085.01), to arrive at a net profit over the life of the lease of $3,515,461.39. This net profit figure would also represent the total return if the $999,999.00 received for the assignment were to be invested at 6.2% over the remaining term of the lease.

11. Petitioner introduced in evidence other calculations of rental income over the life of the lease based on percentages differing from the above-described "worst case scenario". These calculations reflected 6% and 9% rent increases for the rent-stabilized apartments and 0%, 4%

and 6% rent increases on the rent-controlled apartments. Mr. Migdol noted that rental increases in the rent-stabilized apartments were (historically) never less than 3%, and that on rent-controlled apartments such increases customarily run in the neighborhood of 7%. No explanation was offered as to why the transfer price was set on the basis of the worst case scenario, other than the statement that if the lease were assigned for $1,000,000.00 or more, petitioner would have incurred an immediate gains tax liability. Petitioner's president stated that had he continued to lease the building he would expect to have earned a much greater return than 6.2%. He also noted that by assigning the lease and investing the $999,999.00, he could earn a much greater return than 6.2% and, at the same time, have none of the responsibilities of managing the building. Finally, Mr. Migdol stated that the assignment's effect of relieving petitioner from making any further rental payments under the terms of the lease was "not really a factor because [petitioner] was making money (a net profit) on the lease in any event".

SUMMARY OF THE PARTIES' POSITIONS

12. The Division of Taxation does not dispute that assignment of the lease and transfer of the fee concurrently to the same assignee/transferee results in an ultimate merger of the two interests and a termination of the lease. Rather, the Division of Taxation argues that such lease termination, as well as the fact that the lease may have been inherently profitable (i.e.____, that rents from the subleases paid to petitioner exceeded the amount of petitioner's rent and operating expense payouts), are irrelevant in determining consideration. The Division asserts that under the plain terms of the statute (Tax Law §§ 1440[a] and 1443.1) petitioner transferred an interest in real property, the consideration for which was $999,999.00 in cash plus the present value of the remaining lease payments. Since latter present value would clearly exceed $1.00, the Division maintains that the transaction was for a total consideration in excess of $1,000,000.00, hence does not qualify for exemption under Tax Law § 1443.1, and that the imposition of tax and the denial of refund was appropriate.

13. Petitioner asserts, by contrast, that the transaction qualifies for exemption under Tax

Law § 1443.1 as being for a consideration less than $1,000,000.00. More specifically, petitioner asserts that the remaining lease payments, if treated as consideration, should be valued at either: (a) zero because the merger of interests described above extinguished the remaining lease payments and any value therein or, (b) at some negative number because the projected furture income to be generated from sub-leases would exceed the future expenses, including rental payments, to be made by petitioner under the lease. Therefore, petitioner asserts that the only consideration received was the selling price of $999,999.00 and that exemption should be afforded under Tax Law § 1443.1.

14. By its brief, petitioner raised for the first time a question as to its original purchase price for the leased premises. In that petitioner had sought a Statement of No Tax Due based on full exemption under Tax Law § 1443.1, the question of original purchase price allowable as a reduction to consideration and, ultimately, as a reduction in the amount of gain (and hence gains tax due) was never raised. The Division of Taxation concurs that this question was never addressed and also admits, in response to petitioner's brief, that should the Division of Taxation prevail on the question of exemption (the $1,000,000.00 exemption), the Division would nonetheless allow such original purchase price amount as is verifiable and would, accordingly, reduce the amount of tax due.

CONCLUSIONS OF LAW

A. Tax Law § 1441, which was effective as of March 28, 1983, imposes a tax at the rate of 10% upon gains derived from the transfer of real property within New York State. In turn, "gain" is defined by Tax Law § 1440.3 as "the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price".

B. Included among those items constituting an "interest" in real property is, inter alia, a leasehold interest (Tax Law § 1440.4). In turn, Tax Law § 1440.7 defines "transfer of real property" as "the transfer...of any interest in real property by any method,

including...assignment...". Here, there is no dispute that the assignment of the subject net lease by petitioner constituted a "transfer of real property" potentially subject to gains tax.

C. Tax Law § 1440.1(a) defines "consideration" as follows:

> "Consideration means the price paid or required to be paid for real property or any interest therein.... Consideration includes any price paid or required to be paid, ...including the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether the underlying indebtedness is assumed or taken subject to. Consideration includes the cancellation or discharge of an indebtedness or obligation."

D. Tax Law § 1443, insofar as relevant to this matter, provides as follows:

> "A total or partial exemption shall be allowed in the following cases:
>
> 1. If the consideration is less than one million dollars; provided, however, for the purpose of the application of this exemption only, consideration shall be deemed to also include:
>
> * * *
>
> (c) in the case of an assignment of a lease by the lessee, the value of the remaining rental payments required to be made pursuant to the terms of such lease."

E. Pursuant to Tax Law §§ 1440.7, 1440.1, 1443.1(c) and 20 NYCRR 590.31(a), the consideration received with respect to the assignment of a leasehold or sublease is to be determined by adding together the cash received, the amount of any note or mortgage (or other encumbrance) and the value of the remaining rental payments called for under the terms of the leasehold or sublease (see___ 52 Fulton Street Distributors, Ltd. v. State Tax Commn., Albany County, Special Term, July 20, 1987, Williams, J.). However, pursuant to Tax Law § 1443.1(c) the value of the remaining rental payments is to be included in consideration only for purposes of applying the $1 million exemption (Tax Law § 1443.1[c]; 20 NYCRR 590.31 [a]). Such value is not taken into account for purposes of calculating the gain on the transfer, either in consideration or original purchase price (Matter of Festival Leasehold Co., Tax Appeals Tribunal, January 20,

1989), and thus is not itself subjected to tax.

F. In this case, petitioner assigned the net lease and received cash consideration of $999,999.00. In addition, pursuant to Tax Law § 1443.1(c), petitioner was specifically required to include the present value of the rental payments in the calculation of total consideration for assignment of the lease, at least for purposes of determining whether such total consideration was less than the $1 million dollar exemption threshold. Given that the cash consideration for the assignment was $999,999.00, petitioner would thus be entitled to exemption under Tax Law § 1443.1 only if the present value of such rental payments were less than $1.00. In turn, and without making precise calculations, it is abundantly clear that the present value of the remaining annual rental payments under the terms of the lease was well in excess of the $1.00 necessary to bring the consideration in this matter over the $1 million exemption threshold. Accordingly, the Audit Division properly determined that the transfer in question did not qualify for exemption under Tax Law § 1443.1 (see___, Matter of Festival Leasehold Co., supra; Matter of Harvey Auerbach v. State Tax Commn., ___ AD2d ___ [3rd Dept 1988]; Matter of 52 Fulton Street Distributors, Ltd. v. State Tax Commn., supra).

G. Petitioner advances two arguments which, if accepted, would result in exemption. First, petitioner posits that its assignment of the leasehold interest together with sale of the fee interest (by the owner/lessor) to the same entity (221-21st St. Assoc.) results in a merger of these interests, extinguishment of the lease and elimination of all remaining rental payments thereby requiring a zero valuation on such payments as consideration under Tax Law § 1443.1(a). Second, petitioner argues that even if a value of the rental payments is included in consideration, the inherent profitability of the net lease, as described, means that petitioner did not ultimately gain by being relieved of the obligation to make rental payments. In effect, petitioner argues that its net rent was zero, to wit that any benefit derived from being relieved of making rental payments is negated by the fact that petitioner had to give up a profitable lease (a "net asset") in order to obtain such rental release "benefit". Petitioner would argue that it gave up more than it

received, and would thus assign a negative consideration value to such rental release.

H. With regard to petitioner's arguments, transferors are, within the confines of their own negotiating skills, free to determine the amount at which they will sell, transfer or assign their interests in property. Petitioner negotiated with the assignee, presumably at arm's length, and agreed to assign its net lease for the amount of $999,999.00, knowing that such action (assignment) would also serve to release petitioner from the requirement of making any future rental payments under the terms of the lease. Being relieved of such an expense (whether by merger of leasehold and fee interests or otherwise) can be viewed only as a benefit, notwithstanding that sublease income received by petitioner was more than adequate to cover such rental payment expenses as well as all other lease expenses. The fact that such a rental payment release may be a more obvious benefit in instances where a lease is unprofitable (i.e. by eliminating an "out-of-pocket" expense) it is still a benefit to be relieved of rental expense even where a lease is profitable. Petitioner's calculations based on the so-called "worst case scenario", while presumably acceptable to petitioner, leave open the question of why petitioner assigned the lease for the cash amount of $999,999.00, when in petitioner's own estimation the lease was so much more valuable. This line of argument indicates, if anything, that petitioner short-changed itself.

I. In any event, there is no language in Article 31-B which would allow the value of the remaining lease payments, statutorily required to be included in consideration, to be eliminated therefrom because the lease assigned was (or was projected to be) profitable. Thus, the fact that rental payments under the lease were more than offset by rental income does not negate the fact that such payments were themselves an expense of which petitioner was relieved upon assignment (see Finding of Fact "5"). [2] In addition, the fact that after the assignment there were

---

[2]As described, the terms of the lease provide for release from all lease obligations upon assignment and notification thereof, unless the lessee/assignor was in default of any lease term. It is presumed, given the lack of any evidence to the contrary, that petitioner was not in

no more lease payments to be made does not mandate a zero value for such payments as were required of petitioner until assignment and of which petitioner was relieved upon assignment. Accordingly, petitioner's argument that no benefit obtained and thus no positive value should be given to the remaining rental payments is rejected.

K. Petitioner has claimed (in the alternative) and the Audit Division has agreed, that petitioner should be entitled to a reduction in the amount of gain subject to tax based upon allowance of whatever amount is verifiable as petitioner's original purchase price ("O.P.P.") for the subject net lease. Accordingly, this matter must be remanded to the parties for purposes of determining, upon petitioner's submission, the amount of petitioner's O.P.P. for the net lease.[3]

L. The petition of Macbet Realty Corp. is hereby denied; the Audit Division's denial of petitioner's claim for refund is sustained; and the matter is remanded to the parties for calculation, upon submission by petitioner, of petitioner's original purchase price and, ultimately, calculation of such refund if any as may be due petitioner premised thereon.

DATED: Albany, New York

_____

ADMINISTRATIVE LAW JUDGE

---

default and was released upon assignment. Moreover, even if petitioner was in default, release would nonetheless occur upon the merger of interests as described. Finally, it is noted that subsequent to the lease and fee transfers, the assignee (221-21st St. Assoc.) and the lessor (Mr. Levine) in fact also executed a document by which the lease was formally surrendered.

[3]Notwithstanding such remittal to the parties for calculation of O.P.P., petitioner should bear in mind the statutory time period within which any exception to this determination must be filed (see___, Tax Law § 2006.7).